RIGHT OF A STOCKHOLDER, SUING IN BEHALF OF A CORPORATION, TO COMPLAIN OF MISDEEDS OCCURRING PRIOR TO HIS ACQUISITION OF STOCK.

DURING the past thirty-five years there has grown up in this country a considerable body of legal expression to the effect that, as a principle of equity, a stockholder suing in the right of a corporation to redress wrongs done the company, must have owned his stock at the time the wrongs were committed or must have had his shares devolve upon him thereafter by operation of law. The purpose of this article is to differ from such opinion.

It is difficult to suggest any sound theory whereby a stockholder suing in behalf of the corporation, and whose litigation if successful redounds to the benefit of all stockholders, should have an arbitrary limitation placed upon his right to sue. Corporate stock entitles the owner to share in all of the corporate assets, among which must be counted causes of action belonging to the corporation, and one of the most characteristic benefits of corporate organization is the continuing estate thereby created. The stockholder has no right to any specific part of the corporate assets: his rights are those ordinarily possessed by the holder of a chose in action,[1] which in the end are litigious rights. Again, the transferable value of shares is impaired if once it be understood that a transfer operates to cut off rights which the transferor would have had, and wrongs are imposed on purchasers who only on becoming stockholders can inspect the books of the company or otherwise, as matter of right, examine into corporate transactions. This is an answer, also, to the suggestion that a person purchasing stock should take the corporate situation as he finds it: why should he do so when he buys in ignorance of wrong done, and why should wrongdoers be given a shield against attempts to right the wrongs?

[1] Colonial Bank *v.* Whinney, 11 App. Cas. 426, 440, 447–8. See also the excellent opinions in the same cause in the Court of Appeal by Cotton, Lindley, and Fry, L. JJ., 30 Ch. D. 261, 275, 282, 286.

The upholder of the view that a stockholder should not be permitted to sue for misdeeds occurring before his acquisition of stock, will answer with the claim of expediency: he will urge the undesirability of corporations being subjected to litigation and to having their internal dissensions aired in the courts. Certainly, however, the argument of hurting the credit of a company by litigation against it is counterbalanced by the prevention of fraud, breach of fiduciary obligation, or oppressive conduct by those in control. Moreover, see how the stockholder suing on behalf of the corporation is restricted by well-established limitations: he has no standing unless the corporation itself refuses to seek reparation for the wrongs done it.[1] Therefore he must first attempt to induce the directors, as they ordinarily represent the corporation, to take the desired action,[2] or must show some reason why application to them would be futile;[3] as, for example, that they themselves are the wrongdoers and would therefore refuse to sue or else would have the conduct of litigation to whose success they would necessarily be opposed.[4] And a mere naked demand is not enough. An earnest, not a simulated effort is required, and the stockholder must furnish the directors with the reasons which, if they refuse, he will allege in his bill, or else have no standing when he files it.[5] Failing in relief from the directors and if time permits calling a stockholders' meeting, unless the wrongdoers dominate both stockholders and directors,[6] he must attempt to obtain action through the stockholders, by the election of directors who will do their duty, or must otherwise seek to move the stockholders.[7] And except in cases of fraud,[8] the determination of the majority stockholders not to litigate will be conclusive.[9]

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1 Porter *v.* Sabin, 149 U. S. 473, 478.

2 Corbus *v.* Alaska, etc., Mining Co., 187 U. S. 455, 465.

3 Siegman *v.* Maloney, 65 N. J. Eq. 272.

4 Bennett *v.* American Malting Co., 65 N. J. Eq. 375, 377; Knoop *v.* Bohmrich, 49 N. J. Eq. 82; Brewer *v.* Proprietors of the Boston Theatre, 104 Mass. 378, 387.

5 Doherty *v.* Mercantile Trust Co., 184 Mass. 190.

6 Mason *v.* Harris, 11 Ch. D. 97, 107; Bigelow *v.* Calumet & Hecla Mining Co., 155 Fed. 869, 879; Wineburgh *v.* U. S., etc., Co., 173 Mass. 60, 62; Montgomery Light Co. *v.* Lahey, 121 Ala. 131, 135.

7 L. & N. R. R. Co. *v.* Neal, 128 Ala. 149; Jones *v.* The Pearl Mining Co., 20 Colo. 417; Wolf *v.* Shortridge, 195 Pa. St. 191.

8 Atwool *v.* Merryweather, L. R. 5 Eq. 464, note; Brewer *v.* Proprietors of the Boston Theatre, 104 Mass. 378, 395.

9 Foss *v.* Harbottle, 2 Hare 461; Dunphy *v.* Trav. Newspaper Ass'n, 146 Mass. 495, 497. It has even been held that a majority of the stockholders may ratify actual

Ag in, the suitor must be a *bona fide* stockholder. He cannot have a few shares given him by a rival company and be maintained in his suit.[1] He must not have been guilty of acquiescence in the wrong,[2] and acquiescence has been defined as neglect promptly and actively to condemn the unauthorized act by suit.[3] Nor must he have been guilty of laches.[4] Neither must the corporation have lost the right to sue through its own laches,[5] nor by the assent of all the stockholders to the act assailed.[6] The ordinary rule applicable to choses in action, namely, that the transferee takes them *cum onere*, prevents suit by a transferee when the person from whom he derived his stock would have been barred from suit by laches or acquiescence.[7]

The above requirements and the fact that when a stockholder purporting to sue for the corporation is defeated he cannot recover costs and attorneys fees,[8] should sufficiently guard the corporation against the prosecution of frivolous or vindictive suits.

No English case will be found, I believe, which holds that a stockholder may not sue to redress wrongs simply because they were committed before he acquired his stock. On the contrary, Lord Cairns, in the case of Seaton *v.* Grant,[9] refused a motion to take a bill from the files where the plaintiff had bought five shares solely for the purpose of filing the bill, and Chelmsford, L. C., granted an injunction to a plaintiff who had bought his shares shortly before filing and to enable him to file his bill.[10]

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fraud, if *intra vires*, against the protest of the minority. Kessler *v.* Ensley Co., 123 Fed. 546.

1 Forrest *v.* Manchester, etc., Ry. Co., 4 De G. F. & J. 126, 130; Rogers *v.* The Oxford, etc., R. R., 2 De G. & J. 660, 674.

2 Post *v.* Beacon, etc., Co., 84 Fed. 371; Wormser *v.* Metropolitan St. Ry. Co., 184 N. Y. 83; Powers *v.* African Tug Co, [1904] 1 Ch. 558.

3 Rabe & Cross *v.* Dunlap, 51 N. J. Eq. 40, 48.

4 Peabody *v.* Flint, 6 Allen (Mass.) 52; Kent *v.* Quicksilver Mining Co., 78 N. Y. 159, 185; Moore *v.* The Silver, etc., Mining Co., 104 N. C. 534, 546.

5 Kessler *v.* Ensley Co., 123 Fed. 546, 550; s. c. 141 Fed. 130; aff. 148 Fed. 1019.

6 Old Dominion, etc., Co. *v.* Lewisohn, 148 Fed. 1020.

7 Kent *v.* Quicksilver Mining Co., *supra;* Venner *v.* At., T. & S. F. R. Co., 28 Fed. 581, 591; Farwell *v.* Babcock, 27 Tex. Civ. App. 162, 173; Ffooks *v.* The Southwestern Ry. Co., 1 Smale & G. 142. See, however, Parsons *v.* Joseph, 92 Ala. 403.

8 Louisville Bridge Co. *v.* Dodd, 27 Ky. L. Rep. 454, 455, 85 S. W. 683; McCourt *v.* Singers-Bigger, 145 Fed. 103, 113, 114.

9 L. R. 2 Ch. 459.

10 Bloxam *v.* Metropolitan Ry. Co., L. R. 3 Ch. 337. See Salisbury *v.* Metropolitan Ry. Co., 38 L. J. Ch. 249, 251.

Moreover, in this country, as late as 1875, the Supreme Court of New Hampshire,[1] in overruling a demurrer interposed for failure to allege that the plaintiffs were owners of stock at the time of the wrongs complained of, declared that no authority was referred to in support of it, and that the court saw no sound reason upon which it could be sustained. Since then, however, a contrary view has found support, owing, it is submitted, to a misapprehension of the scope and purpose of a rule of practice adopted by the Supreme Court of the United States. This rule, the 94th, was promulgated January 23, 1882,[2] and is as follows:

> "Every bill brought by one or more stockholders in a corporation, against the corporation and other parties, founded on rights which may properly be asserted by the corporation, must be verified by oath, and must contain an allegation that the plaintiff was a shareholder at the time of the transaction of which he complains, or that his share had devolved on him since by operation of law; and that the suit is not a collusive one to confer on a court of the United States jurisdiction of a case of which it would not otherwise have cognizance. It must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders, and the causes of his failure to obtain such action."

Appeal to the federal courts by corporations through collusive suits brought by their stockholders had resulted with great frequency after the decision in 1855 of the case of Dodge *v.* Woolsey.[3] That was a suit for injunction, brought by Woolsey, a citizen of Connecticut and a stockholder in an Ohio bank, against the bank, its directors, and one Dodge, a state tax collector, to prevent the bank from paying and the collector from receiving the tax, imposition of which it was alleged would impair the bank's contract with the state and destroy the bank. Severe penalties would have resulted from refusal to pay the tax. The directors of the bank had been requested by the plaintiff and had refused to take action because of the obstacles in the way of testing the law in the courts of the state.[4] Under these circumstances the Supreme Court held that the action of the board of directors was not merely an error of judgment, but a breach of duty, and finding that the state had passed an act violating the obligation of its contract with

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[1] Winsor *v.* Bailey, 55 N. H. 218, 221.

[2] 104 U. S. ix.

[3] 18 How. (U. S.) 331.

[4] P. 340.

the bank, allowed the injunction. When it was urged[1] that the suit was a contrivance to confer jurisdiction on the federal court, the court replied that that should have been proved by the defendants and would not be presumed. Thereafter, it became the regular practice either to have a non-resident stockholder sue the corporation, or if there were no non-resident stockholder, to have a few shares transferred to some non-resident who would, upon refusal of the board of directors to act, bring suit in the federal court. This narrative will be found recounted with some indignation by Justice Miller in the case of Hawes *v.* Oakland,[2] decided in the October Term 1881, where the stockholder, a citizen of New York, sued a California water works corporation and the city of Oakland, California, to prevent the company furnishing water free to the city for all purposes, with no obligation, it was maintained, on its part to do so, and with the alleged result that the dividends on the plaintiff's stock were diminished and its value impaired. Justice Miller was determined that collusive suits in the federal courts should end. He distinguished the case of Dodge *v.* Woolsey on the ground that there the injury was one which threatened to disrupt the corporation by the permitted payment of an unconstitutional tax, whereas the furnishing of water to the city of Oakland for all purposes he regarded as not beyond the power of the corporation, and conduct which might have been the exercise of highest prudence. There was no irremediable injury of any kind, and nothing to show that a *bona fide* request had been made of the directors to bring the suit. The following paragraph appears in the case:[3]

"The efforts to induce such action as complainant desires on the part of the directors, and of the shareholders when that is necessary, and the cause of failure in these efforts should be stated with particularity, *and an allegation that complainant was a shareholder at the time of the transactions of which he complains, or that his shares have devolved on him since by operation of law*,[4] and that the suit is not a collusive one to confer on a court of the United States jurisdiction in a case of which it could otherwise have no cognizance, should be in the bill, which should be verified by affidavit."

The phrase italicized, stated in an opinion much of which is a diatribe against attempted fraud on the jurisdiction of the court,

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[1] P. 346.
[2] 104 U. S. 450.
[3] P. 461.
[4] The italics are the writer's.

and without authority quoted or argument advanced to support it, has been the chief justification for the dicta of state courts and the contention of law writers, that stockholders cannot sue for wrongs occurring before their acquisition of stock.

The 94th equity rule was adopted shortly after this decision was rendered, and after the credulity exhibited in Dodge *v.* Woolsey had given way to well-grounded suspicion evidenced in it and also in the case of Huntington *v.* Palmer,[1] decided at the same term and reported in the same volume, where a stockholder had sued in behalf of the corporation, and Justice Miller dismissed the bill because there was "nothing to repel the reasonable presumption that parties were improperly and collusively made in order to invoke the jurisdiction of the federal court." It certainly is not a rule of equity to impute fraud to a suitor, nor is it a requirement that a bill shall be verified by oath.[2] And further, the 94th rule does not apply in cases where the court has jurisdiction irrespective of citizenship under the Constitution or laws of the United States.[3]

Nothing need be added, however, in view of Justice Miller's explanation of the reason for equity rule 94, furnished in the case of Quincy *v.* Steel.[4] He therein mentions the many collusive suits brought before and after the attempt to remedy the evil by the act of March 3, 1875. He refers to the cases of Hawes *v.* Oakland and Huntington *v.* Palmer, and says[5] that "In order to give effect to the principles there laid down, this court at that term adopted rule 94 . . ." And later in the opinion[6] he specifically refers to the failure of the complainant in the case before him to comply with "the rule of practice laid down for equity courts in such cases . . ." Indeed, this must be a rule of practice, since it is only such rules that the Supreme Court is authorized to make, and it cannot by rule alter the substantive law.[7]

Since this rule was established, the federal courts, in suits begun in them, have necessarily followed it,[8] and their decisions

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[1] 104 U. S. 482.

[2] Hughes *v.* Northern Pac. Ry. Co., 18 Fed. 106; Groel *v.* United Electric Co. of N. J., 132 Fed. 252, 257; Maeder *v.* Buffalo Bill's Wild West Co., 132 Fed. 280 (holding that the requirement of verification does not apply on removal).

[3] Kimball *v.* City of Cedar Rapids, 99 Fed. 130, 131; Ball *v.* Rutland, 93 Fed. 513.

[4] 120 U. S. 241.

[5] P. 245.

[6] P. 248.

[7] 1 Mor., Priv. Corp., 2 ed., § 269.

[8] Dimpfell *v.* O. & M. Ry. Co., 110 U. S. 209; Bimber *v.* Calivada, etc., Co., 110 Fed. 58.

should not therefore be regarded as authority against the subsequent stockholder in jurisdictions where the rule does not obtain.[1] This has been decided in a number of states where a subsequent stockholder is allowed to sue.[2]

In the case of Forrester *v.* Boston, etc., Mining Co.[3] it is asserted that the proposition that a transferee of stock gets at least the rights of the prior holder is so well established, and rests upon such solid foundation, that the citation of authorities in support of it is useless. On the other hand, editorial comment in 1902 in a law magazine[4] on the case of Farwell *v.* Babcock,[5] which, by the way, went on the ground that the assignor of the plaintiff had assented to the act complained of, and expressly disclaimed deciding that under no circumstances could a stockholder sue to set aside fraudulent contracts made with the company or its board of directors unless he owned his stock at the time of the wrong, finds the weight of authority just the other way. Examination of the cases relied on, however, shows that they do not support this latter contention. In two of them the complaining stockholders were guilty of acquiescence for years, and also failed either to make demand on the directors to conduct the litigation or to furnish a reason for failure to make the demand.[6] In another case all the stockholders had consented to the act complained of.[7] And in still another the corporator was barred by participation of his transferor in the wrongful act.[8] If a stockholder were not barred under such circumstances, it might be that he would be attacking the very stock by virtue of the ownership of which he sues.[9]

The most elaborate attempt in a state court to treat the federal

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1 Evans *v.* Union Pac. Ry. Co., 58 Fed. 497.

2 Montgomery Light Co. *v.* Lahey, 121 Ala. 131, 136; Parsons *v.* Joseph, 92 Ala. 405; Miller *v.* Murray, 17 Colo. 408, 415; Forrester *v.* Boston, etc., Mining Co., 21 Mont. 544, 550, on rehearing, *Ibid.* 565; City of Chicago *v.* Cameron, 22 Ill. App. 91, 104; Tevis *v.* Hammersmith, 31 Ind. App. 281, rehearing denied and appeal to supreme court dismissed; Bennett *v.* Am. Malting Co., 65 N. J. Eq. 375, 377–8; Dissette, Exec. *v.* Lawrence, etc., Co., 9 Oh. Cir. Ct. Rep. (N. S.) 118, 120; O'Connor *v.* The Virginia, etc., Co., 46 Misc. (N. Y.) 530, 535–6. See also Ramsey *v.* Gould, 57 Barb. (N. Y.) 398; Hanna *v.* Lyon, 179 N. Y. 107, 110.

3 21 Mont. 544.

4 54 Cent. L. J. 381.

5 27 Tex. Civ. App. 162.

6 Alexander *v.* Searcy, 81 Ga. 536, 544–7; Dimpfell *v.* O. & M. Ry. Co., 110 U. S. 209.

7 Clark *v.* American Coal Co., 86 Iowa 436.

8 United Electric Securities Co. *v.* Electric Light Co., 68 Fed. 673, 675.

9 Venner *v.* At., T. & S. F. R. Co., 28 Fed. 581, 591.

rule as one expressive of general equity principles is found in the Home Fire Insurance Co. *v.* Barber,[1] where the court says that the right of suit is for the special injury to the stockholder,[2] and that he does not in buying shares buy his vendor's right of action for past injuries.[3] The case confounds suits by the stockholder for himself, and cases where he sues in the right of the corporation. Apparently, too, all of the stockholders had consented to the wrong complained of. The argument that the federal rule is one of equity, because if intended only to guard against collusive suits it would have been limited to cases in which the suitor's vendor was a citizen of the same state as the corporation, obviously proceeds from insufficient reading of the case of Hawes *v.* Oakland, where, if the rule had been as maintained, it would not have reached the complainant.

Although the federal courts are bound to follow the rule in cases begun in them, the question of their so doing in removable cases is important. Federal courts will decide questions of general law for themselves,[4] follow their own decisions, and not be bound by decisions of the state from which a case is removed; but if the federal decisions on a question rest on a rule of practice only, then a federal court on removal should follow the state decisions. It has been decided within the year,[5] in the federal Circuit Court for the Southern District of New York, that the 94th rule governs in a cause removed from a state court where a stockholder need not have owned his stock at the time of the wrong of which he complains. The court emphasizes the fact that Hawes *v.* Oakland was decided before the rule was promulgated; but it is submitted, nevertheless, that the statement therein that subsequent stockholders cannot redress corporate wrongs was dictum, and that the real ground of decision of Hawes *v.* Oakland was the collusive nature of the suit, and the fact that no irreparable injury was shown and no demand first made upon the acting body of the corporation. The court was also influenced by the anomalous result[6] which would refuse a suitor a cause of action if his suit were originally begun in the federal court, and

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[1] 67 Neb. 644.

[2] P. 658. *Cf.* Zinn *v.* Baxter, 65 Oh. St. 341, 365.

[3] P. 650.

[4] Burgess *v.* Seligman, 107 U. S. 20.

[5] Venner *v.* Great Northern Ry. Co., 153 Fed. 408; *cf.* Evans *v.* Union Pac. Ry. Co., 58 Fed. 497.

[6] P. 417.

would allow it if removed there. While not entirely relevant perhaps in this discussion of the theory upon which a stockholder's suit for the corporation may be maintained, it may with deference be suggested in answer that the result is equally deplorable when a suitor begins a good action in a state court and is defeated by removal. The unfortunate result of the rule limiting causes of action to stockholders owning stock contemporaneously with the commission of the wrong, is clearly illustrated in the case. A stockholder holding stock worth $100,000 was prevented thereby from maintaining an otherwise good cause of action on behalf of the corporation.

It is, of course, settled law that a person cannot maintain suit for the corporation after he ceases to be a stockholder.[1] The consequence is that if there be but one good man in corporate Gomorrah and he sells his stock, no one can compel restitution for fraudulent acts.

Murray Seasongood.

CINCINNATI, December, 1907.

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[1] Hanna *v.* Lyon, 179 N. Y. 107, 110, 111; Scanlan *v.* Snow, 2 D. C. App. Cas. 137.